

## Message Text

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STR-07 CEA-01 H-01 L-03 PA-01 /106 W  
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R 141627Z JUL 78  
FM AMEMBASSY LONDON  
TO SECSTATE WASHDC 8140  
TREASURY DEPT WASHDC  
INFO ALL EC CAPITALS  
AMEMBASSY TOKYO  
AMEMBASSY OTTAWA

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DEPARTMENT PASS FEDERAL RESERVE BOARD

E.O. 11652: GDS  
TAGS: EFIN, UK  
SUBJECT: UK POSITION ON THE EUROPEAN MONETARY SYSTEM  
PROPOSALS AND THEIR DOMESTIC POLITICAL IMPACT

SUMMARY: THE CAUTIOUSLY BENEVOLENT BRITISH ATTITUDE  
TOWARD THE FRANCO-GERMAN SCHEME FOR MONETARY COOPERATION  
IS A MIXTURE OF PIQUE, POLITICS AND PRAGMATIC ASSESS-  
MENT OF WHAT IS IN THE UK'S OWN BEST INTEREST. AT LEAST  
SOME OF THE UK'S CONCERNS ABOUT THE FRANCO-GERMAN  
PROPOSAL APPEAR TO BE VALID REFLECTIONS OF BRITISH  
INTEREST. THE PROPOSALS ARE NOT EXPECTED TO HAVE A  
MAJOR IMPACT ON UK DOMESTIC POLITICS IN THE PERIOD  
LEADING UP TO THE ANTICIPATED FALL ELECTION. END SUMMARY

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1. PRIME MINISTER CALLAGHAN WENT TO BREMEN SKEPTICAL  
ABOUT THE FRANCO-GERMAN CURRENCY STABILIZATION SCHEME,  
IN THE DARK ABOUT MANY OF ITS DETAILS, CONCERNED THAT IT  
BEGGED THE REFLATION AND RESOURCE TRANSFER ISSUES,  
TROUBLED THAT IT MIGHT BE DIRECTED AGAINST THE U.S.  
AND PIQUED AT THE WAY SCHMIDT AND GISCARD HAD PUSHED  
THEIR PLAN. UPON ARRIVAL HE WAS TAKEN ABACK BY THE

FIRST SENTENCE STATING "EXCHANGE RATE MARGINS...WOULD BE AT LEAST AS STRICT AS THE SNAKE." BUT HIS ATTITUDE-- AND THAT OF THE TREASURY--SHOULD NOT BE SEEN AS NEGATIVE, BUT RATHER AS AGREEING THAT A ZONE OF MONETARY STABILITY IN EUROPE IS A HIGHLY DESIRABLE OBJECTIVE, AS PART OF THE CONCERTED INTERNATIONAL ACTION NECESSARY FOR ECONOMIC RECOVERY.

THE BRITISH VIEW: POSITIVE, BUT...

2. ESSENTIALLY, THE BRITISH ATTITUDE IS ONE OF CAUTIOUS BENEVOLENCE. THEY SEE THE FRANCO-GERMAN PLAN AS INTERESTING, IF IT MEETS A NUMBER OF CRITERIA. THE UK CONSIDERS THAT TO BE SUCCESSFUL, ANY EC CURRENCY PLAN MUST BE DURABLE, TECHNICALLY FEASIBLE AND REFLECT ECONOMIC REALITY; THERE MUST BE RECIPROCAL OBLIGATIONS WHICH IN TURN WILL ENHANCE THE POSSIBILITIES OF THE SCHEME REMAINING DURABLE. IT MUST BE COOPERATIVE, NOT EXPLOITATIVE. ANY SCHEME WHICH COMES UNSTUCK AND SQUEEZES MEMBERS OUT LIKE PIPS IS NOT IN ANYONE'S BEST INTEREST. THE SNAKE HAS LOST THE UK, ITALY, FRANCE, AND SWEDEN. IF THE FRANCO-GERMAN SCHEME HAS THE SAME RESULT, THE UK CONSIDERS IT WILL BREED INSTABILITY. THE UK IS ALSO DETERMINED THAT IN ANY EC SCHEME, THERE SHOULD BE APPROPRIATE RESOURCE TRANSFER. UK OFFICIALS SAY THEY ARE NOT ASKING FOR HANDOUTS, CONFIDENTIAL

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BUT ARE SEEKING A REDUCTION IN THE SIZE OF PAYMENTS MADE TO THE EC, WHICH ARE CONSIDERED PERVERSE. ONE MANIFESTATION OF THESE IS THE COMMON AGRICULTURAL POLICY.

3. CALLAGHAN AND UK OFFICIALS ARE VERY CONCERNED THAT THE FRANCO-GERMAN PROPOSAL SHOULD NOT HAVE A NET DEFLATIONARY IMPACT, WHICH IN PART EXPLAINS THE PRIME MINISTER'S PROPOSED STUDY AIMING AT CONVERGENCE OF ECONOMIC POLICY, STRENGTHENING THE ECONOMIC POSITION OF THE WEAKER MEMBERS AS PART OF THE COMMUNITY'S ONGOING WORK. IN THE UK VIEW, THE FRANCO-GERMAN PLAN FOR STABILITY SHOULD NOT ARTIFICIALLY HOLD DOWN THE DM, AND OTHER STRONGER CURRENCIES OR FORCE UP WEAKER CURRENCIES AS THE DM APPRECIATES. THIS WOULD POSTPONE RATHER THAN PROMOTE ADJUSTMENT OF THE UNDERLYING ECONOMIC AND STRUCTURAL FUNDAMENTALS. UK OFFICIALS ARE AWARE THAT TO THE EXTENT THE FRANCO-GERMAN PLAN MIGHT CONCEIVABLY RESULT IN A GENERAL UNDERVALUATION OF THE EC'S OWN TRADE-WEIGHTED EXCHANGE RATE, IT COULD PROVOKE DIFFICULTIES FOR THE U.S., JAPAN, AND OTHER NON-EC TRADING PARTNERS, BUT THIS DOES NOT APPARENTLY WORRY

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#### FRENCH AND GERMAN MOTIVATIONS

4. GERMAN MOTIVATION IS SEEN AS MIXED; AS DESIRING TO  
REDUCE DM APPRECIATION, BUT ALSO PROBABLY SINCERELY  
WANTING TO REDUCE INFLATION IN THE EC AND WHAT ARE  
CONSIDERED NOXIOUS EFFECTS OF THE FLOATING RATE SYSTEM.  
GISCARD'S MOTIVATIONS ARE MORE SUSPECT TO UK OFFICIALS:  
DOES HE REALLY FAVOR THE PLAN BUT EXPECT IT TO BOG  
DOWN IN UK RESISTANCE, YET NONETHELESS STRENGTHEN THE  
FRANCO-GERMAN AXIS OR IS HE SINCERE IN SUPPORTING  
SCHMIDT, PARTLY OUT OF ANTI-U.S. REASONS?

#### THE U.K. PUBLIC FACE

5. THE PRIME MINISTER'S REPORT TO THE HOUSE OF COMMONS  
ON THE BREMEN MEETING STRESSED THAT MONETARY STABILITY  
IS A HIGHLY DESIRABLE OBJECTIVE BUT THAT ANY NEW SYSTEM  
THAT WILL LAST MUST TAKE FULL ACCOUNT OF THE ECONOMIC AS  
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WELL AS MONETARY INTEREST OF ITS MEMBERS. THIS EXPLAINS IN PART CALLAGHAN'S SUCCESSFUL PUSH FOR PARALLEL STUDIES TO BE MADE OF THE ACTION THAT IS NECESSARY TO ASSUE A GREATER CONVERGENCE OF THE ECONOMIES OF THE MEMBER COUNTRIES, ESPECIALLY IN SUCH MATTERS AS COMMITMENT TO GROWTH AND TRANSFER OF REAL RESOURCES. THE UK AIM, HE SAID, IS THAT NEW EC SOLUTIONS SHOULD BE ALREED ON THE CONVERGENCE OF ECONOMIES, ON A ZONE OF MONETARY STABILITY AND A TRANSFER OF RESOURCES INSIDE THE COMMUNITY, INCLUDING BETTER USE OF RESOURCES IN THE CAP, THE AGRICULTURE BUDGET BEING CONSIDERED LARGE ENOUGH IF INDEED NOT TOO LARGE.

6. IN PRESENTING HIS COMMENTS ALONG THE ABOVE LINES TO THE COMMONS, THE PRIME MINISTER ALSO STRESSED, IN WHAT WE ARE TOLD WAS A KEY PASSAGE, THAT THE PARLIAMENT WOULD HAVE TO TAKE A DECISION WHETHER IT WISHED TO REMAIN POOR AND INDEPENDENT OR WHETHER IT WAS WILLING TO SACRIFICE SOME POWERS AND BE MORE PROSPEROUS. IN REPLY TO CRITICAL QUESTIONS FROM ANTI-MARKETEERS, CALLAGHAN INDICATED THAT ENTERING AN EC SCHEME MIGHT MEAN GIVING UP SOME CONTROL, BUT THE UK WOULD HAVE TO JUDGE AT THE END OF THE DAY WHETHER IT WAS WORTH GIVING UP THE CONTROL IN ORDER TO BETTER PROTECT STERLING, PROVIDED THE OTHER CONDITIONS WHICH CALLAGHAN HAS ENUMERATED WERE ALSO FULFILLED. THERE IS OBVIOUSLY SOME ROOM FOR COMPROMISE IN THE UK POSITION, BUT ITS CONCERNS ARE DEEPLY FELT AND BASICALLY GENUINE.

NEXT EC STEPS

7. LTOKING AHEAD TO THE JULY 24 FINANCE MINISTERS SESSIONANDTHE DELIBERATIONS IN THE AUTUMN AND WINTER, THE UK CAN BE EXPECTED TO CONTINUE TO PRESS FOR CONSIDERATION OF THE EC CURRENCY PLAN IN A LARGER CONTEXT. IT EXPECTS TO BE SUPPORTED IN THIS AT LEAST BY ITALY AND IRELAND.

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CALLAGHAN WILL CONTINUE TO STRESS HIS FIVE POINTS AND-- SENSITIVE TO HIS RELATIVE STANDING AMONG INTERNATIONAL LEADERS ANDTHEPUBLIC RELATIONS ASPECTS -- HE WILL ATTEMPT TO PORTRAY HIMSELF AS A LEADING INTERNATIONAL STATESMAN ATTEMPTING TO SHAPE WORLD EVENTS IN A LARGER RATHER THAN NARROWER SENSE WITH AN EYE TOWARDS INCREASING ECONOMIC GROWTH AND REDUCING UNEMPLOYMENT.

8. THE NEAR-TERM EFFECTS OF THE BREMEN AND EC SUMMIT ON BRITISH DOMESTIC POLITICS ARE LIKELY TO BE LIMITED, SINCE ANY DECISIONS ON BRITISH PARTICIPATION IN A EURO-

PEAN MONETARY ARRANGEMENT HAVE BEEN PUT OFF UNTIL AFTER THE ANTICIPATED OCTOBER GENERAL ELECTION. AND THE PROXIMITY OF THE ELECTION, COUPLED WITH THE GROWING UNPOPULARITY IN THE UK OF THE EC AND THE ABSENCE OF MEANINGFUL DETAILS ABOUT THE FINAL SCHEME WILL INTERACT TO MINIMIZE THE AREA OF PARTISAN (OR INTERNECINE) CONFLICT. THE LONGER-TERM EFFECTS, OF COURSE, WILL DEPEND ON THE RESULTS OF THE DECEMBER SUMMIT AND THE VARIOUS STUDIES LEADING UP TO IT. SINCE CALLAGHAN HAD INVESTED LITTLE PERSONAL CAPITAL IN THE SUCCESS OF BREMEN -- IN CONTRAST TO HIS HEAVY COMMITMENT TO A SUCCESSFUL BONN SUMMIT -- THE CONSERVATIVES WILL BE FORCED TO TRY TO EXAGGERATE THE DOMESTIC POLITICAL IMPORTANCE OF THE BREMEN MEETING. BUT

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THEY WILL STILL HAVE VERY LITTLE TO SHOOT AT. HOWEVER, CALLAGHAN'S OWN ACTIONS, PARTICULARLY HIS ATTEMPTS TO USE THE PRESS TO ENHANCE HIS IMAGE AS A DEFENDER OF BRITISH INTERESTS, HAVE AIDED THEM TO SOME EXTENT.

9. THAT HAVING BEEN SAID, DOMESTIC POLITICAL CONSIDERATIONS PROBABLY HAD ONLY A SECONDARY INFLUENCE ON HMG'S APPROACH TO BREMEN. CALLAGHAN WENT TO BREMEN DETERMINED

TO SAFEGUARD BRITISH INTERESTS AS HE VIEWS THEM AND TO PROTECT THE TRANS-ATLANTIC LINK FROM A PERCEIVED THREAT. THAT THIS POSTURE WAS HELPFUL DOMESTICALLY WAS A BONUS RATHER THAN A MOTIVATING FORCE. IN HIS VIEW, THE FIVE POINT PLAN HE HAD ADVANCED FOR THE BONN SUMMIT SERVED BRITAIN'S INTERESTS -- MONETARY COOPERATION IS FINE, BUT IT IS NOT AN END IN ITSELF. AND HE CAN PLAUSIBLY CLAIM TO HAVE ACHIEVED HIS OBJECTIVES AT BREMEN, THOUGH HIS PERFORMANCE MAY HAVE APPEARED MORE PETULANT THAN ARTFUL.

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10. DOMESTICALLY, CALLAGHAN'S ATTEMPTS TO MANIPULATE THE PRESS PROBABLY DID HIM MORE HARM THAN GOOD, LEAVING THE IMPRESSION OF A SPITEFUL OR MALADROIT LEADER, NOT A STATESMAN -- AN IMAGE HE HAS BEEN TRYING HARD TO CULTIVATE BEFORE THE ELECTION. HE SOUGHT TO CORRECT THIS IMPRESSION WITH A MEASURED, PRAGMATIC AND BASICALLY POSITIVE STATEMENT TO COMMONS JULY 10, BUT FOUND THAT THE POLITICAL IMPACT OF HIS REMARKS HAD BEEN PRE-EMPTED BY PRESS COVERAGE OF A TREASURY BACKGROUNDER WHICH SEEMED SOMEWHAT AT VARIANCE WITH HIS COMMONS STATEMENT. THE UP-SHOT WAS TO REINFORCE THE POPULAR IMPRESSION THAT THE GOVERNMENT HAD NOT GOTTEN ITS ACT TOGETHER. NEVERTHELESS, WE SUSPECT THAT THE BREMEN MEETING WILL SOON BE OVERSHADOWED BY THE BONN SUMMIT.

11. NEITHER THE BREMEN COMMUNIQUE NOR CALLAGHAN'S SUBSEQUENT STATEMENTS TO THE PRESS HAVE CAUSED SIGNIFICANT DISQUIET WITHIN THE LABOR PARTY, NOR ARE SUCH PROBLEMS LIKELY TO ARISE THIS SIDE OF THE GENERAL ELECTION. BELIEVING THE UK IS MORE LIKELY TO RESOLVE ITS ECONOMIC PROBLEMS IN COOPERATION WITH ITS EC PARTNERS THAN BY IGNORING THE CURRENCY STABILITY PROPOSALS, MRS. THATCHER TOO IS UNWILLING TO SACRIFICE LARGER BRITISH INTERESTS FOR CURRENCY STABILIZATION. BUT LACKING DETAILS OF THE FRANCO-GERMAN PROPOSAL -- AND THE TORIES KNEW FAR LESS ABOUT IT THAN DID THE GOVERNMENT -- AND ITS IMPLICATIONS, SHE AND OTHER TORY SPOKESMEN WERE PERFORCE GUARDED IN THEIR RESPONSE. THIS UNCERTAINTY MEANS THEIR ATTACKS ON CALLAGHAN MUST BE LIMITED TO HIS ATTITUDE AND SUPPOSITIONS ABOUT AS YET UNIDENTIFIED DETAILS OF WHATEVER MAY EMERGE IN DECEMBER -- HARDLY THE STUFF FROM WHICH CUTTING CAMPAIGN ISSUES ARE MADE.

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12. IRONICALLY, THE CONSERVATIVE RIGHT-WINGERS, WHO TEND TO BE ASCENDANT IN THE PARTY AND MIGHT BE EXPECTED TO BE FAVORABLY DISPOSED TO MOVES TOWARD EMU, HAVE BEEN CAUTIOUS, WHILE THE HEATH WING OF THE PARTY, WHICH MIGHT LOGICALLY BE EXPECTED TO BE LESS ENTHUSIASTIC, HAS BEEN MOST CRITICAL OF CALLAGHAN'S PRAGMATIC BUT SKEPTICAL POSTURE. THEIR RESPECTIVE POSITIONS, HOWEVER, ARE DIRECTED BY ATTITUDES TOWARD EUROPE, RATHER THAN ECONOMIC DOCTRINE -- THE THATCHERITES TEND TO BE CONCERNED ABOUT THE DILUTION OF BRITISH SOVEREIGNTY WITHIN THE EC AND NOT SOLELY BECAUSE OF DOMESTIC POLITICAL CONSIDERA-

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TIONS, WHILE HEATH AND FRIENDS TEND TO  
HAVE A PRO-EUROPEAN OUTLOOK.

13. BRITISH INDUSTRY, THOUGH ATTRACTED BY THE PERCEIVED ADVANTAGES OF MORE STABLE EXCHANGE RATES, WILL BE CONCERNED ABOUT ITS ABILITY TO REMAIN COMPETITIVE WITHIN THE FRANCO-GERMAN PLAN AS PRESENTED AT BREMEN. TO THE EXTENT THE UNIONS WILL BE CONCERNED ABOUT THE PROPOSALS IN THE

NEAR-TERM, THEIR CONCERN WILL FOCUS ON THE DEGREE TO WHICH A DEFLATIONARY BIAS MIGHT INCREASE UNEMPLOYMENT AND HOLD BACK GROWTH IN BRITAIN AND THE EC. INDEED, THE BRITISH TRADE UNIONS ARE COMMITTED TO REFLATIONARY MEASURES AS A DEVICE TO REDUCE UNEMPLOYMENT, AND TRADE UNION LEADERS ARE BECOMING DISENCHANTED WITH ARGUMENTS THAT LINK INFLATION AND UNEMPLOYMENT. THEY SEE BRITISH UNEMPLOYMENT AS SUSCEPTIBLE ESSENTIALLY TO INTERNATIONAL RATHER THAN NATIONAL SOLUTIONS. IN BOTH CASES, THE NET IMPACT IS LIKELY TO BE SMALL POTATOES IN THE CONTEXT OF  
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BRITISH POLITICS GENERALLY AND AN ELECTION CAMPAIGN SPECIFICALLY. THIS SAID, THOSE DISSATISFIED WITH THE CURRENT STRUCTURE OF THE EC, INCLUDING CALLAGHAN, SEE THE PROPOSALS AS A MEANS TO WIDEN THE SCOPE OF DISCUSSION IN ORDER TO REDRESS EC POLICY IN OTHER AREAS TO BRITISH ADVANTAGE.

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